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ABSTRACT

How does one tell which higher education institutions should go out of business? The National Commission on the Financing of Post-Secondary Education took the view that financial distress was only in part a financial problem. An essential key to the problem is a determination of the financial impact on educational objectives. Institutional survival is inextricably linked to institutional policy, and if institutional policy does not somehow mesh into the overall educational scheme of things--which includes public policy concerns and needs--institutional survival will sooner or later come into question, or at least into difficulties. The Commission's major recommendation on the subject was that there be developed a set of national standard indicators to determine the relative financial health of the different types of postsecondary educational institutions. There should be a method for reporting budget information programmatically so that one might observe what happens to specific programs when money flows change; furthermore, there should be ways to determine how specific educational activities affect educational outcomes so that there will be some evidence on how much disappearing monies weaken the educational effort. It is quite appropriate for the federal government to play the role of stabilizer and even the role of subsidizer to aid higher education institutions. The appendix includes charts related to the text. (Author/PG)

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MEASURING FINANCIAL DISTRESS

Remarks prepared for delivery 2:30 p.m., Thursday, July 11
"Analyzing the Report from the National Commission on the Financing of Postsecondary Education"

Hans Jenny
Vice President for Finance and Business
College of Wooster

Preface

Last year, when I had the honor and privilege to work as a member of the staff of the National Commission on the Financing of Postsecondary Education, I contacted many of you.

We tried to send each of you who were kind enough to respond a letter of thanks. Let me take this opportunity to express to you my personal appreciation for your letters.

You took time, effort, and care when you sent me your comments. Your replies were on the overwhelming whole statesman like. They so impressed the staff that we put them all in a binder and made them available to the Commissioners.

It was a moment of pride for me and of gratitude. Pride to be associated with professionals possessing such broad insight, and gratitude that so many of you thought that I might do the cause some good. I am also proud of the fact that I can count on so many of you as personal friends.

A special word of appreciation must be said to George Kaludis who, in a difficult task, tried to guide the deliberations so that they might not end up in recommendations too extreme to implement and too bland so as to be of no interest.

I trust that my own modest efforts have not disappointed you beyond the point of forgiving.

And of course, without the help of all the others on the Commission's staff, last summer would not have been the interesting experience it was.

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I. A few weeks ago I had the pleasure of discussing with the trustees of a private foundation how they might assist institutions in higher education meaningfully. One does not often have a chance to recommend to philanthropists how their much coveted monies should be spent. Normally one comes before them as a beggar.

At one moment in our deliberations--it may have been after the third cocktail--we played with the idea of providing financial and professional assistance so that educational institutions desiring to do so could be helped out of business in a graceful and--to the employees--reasonably painless fashion.

That the topic came up at all is a sign of the times we live in. We dropped it after a while. Somehow a perfectly plausible idea did not seem to be quite right: think of it, a foundation sitting there with all that loot, plotting the disappearance of private colleges.

Somewhere during our brainstorming the question came up: how would we know which institutions should go out of business? After all, even in helping people go out of business one should not squander one's precious philanthropic monies needlessly!

Yes, how would one tell which institutions should go out of business? While this was not exactly the question before the National Commission on the Financing of Postsecondary Education, it rather elegantly defines our problem when we were trying to cope with the financial distress question.

How would one decide which educational institutions should stay in business? Both public and private!

II. This last question was in many a legislator's mind when the Congress passed the 1972 Higher Education Amendments with a provision for a kind of disaster relief for especially hard pressed institutions. It is in connection with this particular legislation that the question arose as to whether higher educational institutions were suffering extensive and serious financial distress requiring remedial public intervention.

From the start, the National Commission took the view that financial distress was only in part a financial problem, at least as far as both its mandate and public policy were at stake. An essential key to the puzzle would be a prior determination of the financial impact on educational objectives. And since public policy of national scope was involved in the Commission's concerns, its deliberations on financial distress would per force center at least in part on how national public policy objectives might be affected.

The Commission argues that financial distress exists or is of concern to policy makers if and when it prevents the achievement of national or other broad educational policy objectives. Thus, the financial demise of individual educational programs and institutions is not the primary focus chosen by the Commission.

Of course, the financial health of educational institutions is of concern for other reasons than those one associates from time to time with national or public policy. Financial distress in particular is felt acutely by institutions, and to them national policy objectives may matter less than institutional survival.

But institutional survival is inextricably linked to institutional policy, and if institutional policy does not somehow mesh into the overall educational scheme of things--which includes public policy concerns and needs--institutional survival will sooner or later come into question, or at least into difficulties.

For better or worse, however, institutional survival per se is not one of the National Commission's objectives for postsecondary education. And with this, many hard pressed individuals seem to quarrel. While this is their privilege in a society of free speech and free thought, it is my belief that the Commission's view is the correct one.

III. In the process of editing, the Commission's work suffered the fate of many a motion picture: a lot of material ended on the cutting room floor. Some of it deservedly, without a doubt. But there exist a few pieces of data that might have clarified what on third or fourth reading still remains a frustrating experience.

Today I shall not dwell on the statistical evidence and I shall not heat up left-overs in order to determine whether financial distress, serious or otherwise, within the Commission's definition existed prior to going to press. Suffice it to say that what information there was available or consulted provided little, if any, proof of an imminent disaster. Actually, during the period for which financial data were studied, the aggregates for specific groups of institutions were turning around for the better, at least somewhat and slightly.

Although editorially there may have occurred a few derailments, there is no fundamental inconsistency in saying on the one hand that available data and studies do not justify a conclusion that financial distress was then a major problem and on the other hand that the really appropriate data and analysis for such a determination are not yet available.

What the report might have said is that upon more appropriate analysis we might indeed find that there was evidence of financial distress within the Commission's definition of the term. I believe that some studies now in progress will eventually support such a view.

IV. Let me now turn to the Commission's major recommendation on the subject: that there be developed a set of national standard indicators to determine the relative financial health of the different types of postsecondary educational institutions.

The term indicator has at least two meanings here; it refers both to descriptive and to analytical data. And these in turn are of at least three types:

a. Data describing and analyzing the performance and status of educational institutions;

b. Data describing the changing condition of the postsecondary educational enterprise and of its major segments;

c. And data that focus on the several external conditions and forces affecting the post-secondary educational enterprise.

This is really quite a standard package, particularly as far as economic analysis is concerned. For those who are not part of our industry the suggestion that there should be a problem, today, in obtaining promptly and for current use the requisite data sounds ludicrous, and rightly so. I have every sympathy with legislators who ask for the information only to be told that it is not there.

I am not so sympathetic with those legislators who have been withholding funds from those interested in developing adequate higher education statistics. But I must look out into this audience and say: why have we not been more creative in this area? It is a good question, if you forgive my uncharitable insistence, but I shall spare you the sordid details.

Let me touch briefly on two specific suggestions contained in the Commission's report, one pertaining to institutional data, and the other to industry-wide indicators, in that order.

V. The question of financial distress is perhaps best understood in higher education by business and finance officers, particularly when they go beyond the strictly financial in their analysis, When we are at our best--which is, of course, always the case, n'est-ce pas?--we view our institution's finances in the holistic manner that includes total and comprehensive financial analysis coupled with careful program evaluation and optimization in all areas, academic, research, public service, and straight business.

In other words, as financial officers we know exactly how well we are appropriating and using our scarce monetary and at present somewhat ample human resources. Or do we?

Well, ladies and gentlemen, the National Commission tells us that we should know--maybe not know perfectly, but know overall and approximately. And the Commission tells us that we should know when we come with our hands outstretched yelling distress and please support us lest we go out of business.

The Commission asks us to agree on a few things--for instance, on a method for reporting budget information programmatically so that one might observe what happens to specific programs when money flows change; furthermore, we are asked to agree on ways to determine how specific educational activities affect educational outcomes so that we might have some evidence where, when, and how much disappearing monies weaken the educational effort.

The several illustrations provided by the Commission are based on the notion that it ought to be possible to come to a consensus. Institutions in financial distress will have different characteristics than those in sound financial condition, and these characteristics are in the final analysis not solely related to finances.

And where they are centered on finances, these will not focus narrowly on the institution's operating deficit, but on a comprehensive evaluation of the sum total of financial resources: income, expenditures, assets, liabilities, the structure of the debt and of endowments. And we should not forget some measures of the quality of financial and, more generally, of institutional management.

Is it possible to distinguish by institutional types which ones are achieving their educational objectives and are financially viable from those that are not? I believe that it is possible that we can reach a reasonable consensus, and that the Commission did not ask for the impossible. Illustrations are part of the appendix attached to this text.

What the National Commission is implying concerns our conception of effective resources use in higher education. If the task is not necessarily simple, it need not be impossible.

VI. Another type of data mentioned by the Commission are the various price index series that would measure how inflation manifests itself postsecondary education. Three types of deflators are mentioned specifically:

a. A price index that would measure the changing purchasing power of the consumer of educational services, chiefly the students. This would include tuition, fees, room and board charges, books, supplies, transportation, and other standard living costs peculiar to students.

b. A cost or price index measuring the rate of inflation prevalent in the institution's capital budgets, particularly for plant, equipment, and instructional or research technology.

c. And most urgent of all, an index designed to measure the rate of inflation present in the institution's operating budget.

It is almost unbelievable how often legislatures, foundations, and analysts look at the Consumer Price Index in order to determine how much inflation higher education may have experienced. Recent figures published by G. Richard Wynn,[1] presently a doctoral candidate at the University of Michigan, show how much faster higher education inflation has been than that described by either the Wholesale Price Index or the Consumer Price Index.

As a single measure of financial distress, such a price index comes far closer than the much misused deficit information that has come our way all these many years. The exhibits supplied here illustrate clearly why this is so.

VII. Since the publication of the National Commission's report, the economy around us has experienced another dramatic change. The problems in higher education and elsewhere are more vexing than ever. Institutions both public and private are undergoing unaccustomed budgetary change. Concern and anguish are on the increase, and institutional disappearance is once again on the increase.

Those of us in financial and business management tend to keep in rather close touch. We tend to have something of a feel of what is happening at home and around us. But is it not astounding that there are no current statistics telling us promptly what is and has been happening?

If I depart for a moment from viewing the problem of appropriate and timely information as the National Commission saw it, and join you at the institutional level, except for what the Chronicle and ACE or NACUBO tell you in their news stories, what do we really know of the happenings out there?

WE know that there is financial distress within our institutions. What does it take to convince others, many of us wonder. And yet, maybe the taxpayer has a right to ask for a bit more information. And maybe our trade associations ought to be the ones to collect and analyze it. It is my hope, supported by recent efforts by them, that maybe they will be the ones to implement some of the recommendations made in this respect by the National Commission.

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[1] G. Richard Wynn, At The Crossroads: A Report on the Financial Condition of the Forty-Eight Liberal Arts Colleges Previously Studied in "The Golden Years" and "The Turning Point." Ann Arbor, Michigan: Center for the Study of Higher Education, School of Education, The University of Michigan, April, 1974.

It is my sincere belief that we ought to have turnaround information on finances, data annually on institutional budgets not merely on audits, and historical time series for such key variables and ratios as are illustrated in the appendix of this paper. And like the data produced by the U. S. Bureau of Labor Statistics and the Bureau of Economic Analysis for employment, price, and national income data, depending on the type of data element, monthly, quarterly, and annual reporting of estimates is not asking too much. The continuing delays and the absence of key information is really a scandal that no amount of rationalizing will make less damaging.

My objective here today and in some of the illustrations that I have been fortunate enough to disseminate here and there is not to suggest that all of the specific variables mentioned in these exhibits represent the last word in the matter. On the contrary, I should hope that they might form the basis for debate and eventual consensus making. But, ladies and gentlemen, it is past feet-dragging time. Something must be done, and it must be done now.

The fact that we do not officially measure--for instance--the extent of inflation in higher education is becoming a major damaging event. There is talk all around us about the "steady state" when we are in fact engaged in a progressive recession or, worse, depression. If I take my cue from traditional economic analysis, real spending in higher educational institutions has not merely slowed down; in many institutions, on a per student basis, real spending has been declining. This decline may be selective within the institution, but it is there. And declining real economic activity over protracted periods is what is called economic contraction, recession, depression, whatever, depending upon the steepness of the decline. And this is happening in public and private institutions.

If we had an officially blessed and a believable inflation index for our industry, we could make this point dramatically. Today, there are three such inflation measures, either in obscure existence or applied to particular studies. There is the Bureau of Economic Analysis' price deflator for private higher education, probably not known by most of you and therefore unused. Second, there is June O'Neill's deflator that nobody has seen fit to update even annually for more general and official use. And third, there is the effort undertaken by G. Richard Wynn that began much less formally with our joint efforts in The Golden Years and The Turning Point.

The O'Neill and Wynn efforts point to one of those exceedingly frustrating aspects associated with such work: once a good effort is made by an individual, we do not seem to be organized to pick up from there and carry the thing forward. It just sort of dies away. I should hope that this time this will not happen. And you, ladies and gentlemen, can play a key role in not making it die. You are singularly well placed for spearheading the efforts that will be required to make sure that we shall finally have our higher education price index.

It may not have been one of the most earth-shaking recommendations in the annals of commission reporting, but that the National Commission saw the urgency of creating a timely and functional data base for higher education ought to be seen for what it is: a constructive and far-sighted professional suggestion that lies above and beyond party lines and political considerations.

VIII. In conclusion, I should like to return to the matter of financial distress and to the question of how one might deal with it. Assuming that the means exist for determining when and where financial distress impairs the achievement of essential postsecondary educational objectives, what role ought governments play? Let me restrict my observation to the federal government.

It seems to me that it is quite appropriate for the federal government to play the role of stabilizer and even the role of subsidizer. In the case of public institutions, the state already establishes rules of the game that provide price and other advantages to both students and institutions. When the price is skewed by government fiat in favor of one group of institutuions, it is rather presumptuous of their spokesmen to claim that the disappearance of private institutions is chiefly a matter of the free play of the market. Free competition, indeed; you must be kidding!

When we look at American history, the federal government has always helped out private institutions. I am very sorry that the National Commission did not have more courage to tell the representatives of public institutions that they are already privileged and that they are one of the prime reasons for the disappearance of private institutions. Not the only reason, but one of them.

And the Commission could then have more forcefully stated that the role of the federal government has been, is today, and could continue to be tomorrow that of providing a counter-balance. I find it annoying, to say the least, when presidents of public institutions and officials from state universities and community colleges lecture us private fellows as to when we do and when we do not have a right to receive federal or other government monies. I say that it is quite in the American tradition for private business to obtain government help when trouble comes. We protect small businesses. We help entire industries from aircraft and pottery to farming and construction. We can as easily help educational institutions, private and public. I feel that it is not called for to invent a special kind of social philosophy on behalf of private higher education--non-profit variety--than we have in this country for private for-profit education.

Today, financial distress caused by forces other than those directly associated with the educational enterprise touches all institutions, and it transcends the economy in general. Now that we are all in the same boat it might be possible to present a more unified front. It is not the institutions that are at stake; the education of our fine young men and women and of all who must or want to return to school is at stake.

Of the many pleasant things and disturbing positions that I remember from last summer, this context reminds me of the pronounced anti-institutional posture assumed by some on the Commission, often for good reasons. "But institutions are all we have for the job." Nevertheless, it is appropriate to point out that while we may plead for and seek institutional survival, I assume that we do this because it is through our institutions that we educate. And so, institutional financial distress can, does, and has become the distress of education itself.

The ideas and data presented here derive mostly from two sources: First, Chapter Five, "The Incidence of Financial Distress among Institutions of Postsecondary Education" of the National Commission's report entitled Financing Postsecondary Education in the United States; Second, studies undertaken under a Ford Foundation grant in a pilot project designed to construct an index that measures inflation in higher education institutional expenditures.

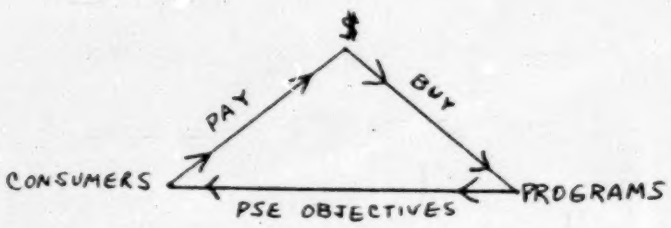
The specific data concerning inflation are based on G. Richard Wynn's work that will be more fully described in his forthcoming doctoral dissertation and of which some preliminary findings appeared in At the Crossroads published by the University of Michigan.

1. Indicators of Financial Distress

Some connection exists among consumers of educational services (mostly students), the programs and activities designed to provide these services, and the finances required to purchase and produce the programs and activities.

The inter-connecting relationship is a set of complex qualitative and quantitative functions, but a simple illustration might look something like this:

Diagram A



One way to look at the National Commission's position on financial distress is to say that the programs and activities must help achieve a set of postsecondary educational objectives; and those who pay for these programs and activities by channeling funds through institutions and students must have some assurance that the outlays produce desired educational outcomes.

2. The Three Basic Variables (At Least in Undergraduate Education)

In terms of financial distress, at least three possible broad classes of variables might be of interest:

a. The nature, quality, and scope of enrollments.
b. The nature, quality, number and mix of educational programs and activities.
c. Financial variables, including income, expenditures, assets, liabilities, and managerial knowhow.

Each set can be described in a more or less extensive list of sub-variables. The tables supplied below provide some suggestions. What we have in mind is information that allows the development of meaningful time series. In other words, we are interested in change over time as well as in qualitative change.

In a dynamic institution (in contrast to the static concept of equilibrium) things change, and the ultimate objective is to find out whether the change is toward deterioration. If enough variables point to deterioration in all three areas the institution can be said to move toward or be in financial distress.

3. The Changing Financial Condition

Although other possible schemes could be used, we should like to suggest a distinction of four major phases:

a. The financially sound institution;
b. The financially weakening institution;
c. Financial distress;
d. Turnaround or disappearance (bankruptcy, takeover, merger, fundamental program change, etc.).

It would be necessary to reach a consensus of how the several variables would have to behave under each heading. The exhibits that are attached provide space to include appropriate descriptors that would be derived from the historical data, the evaluations, and from interpretations of the information. The descriptors can be quantitative, impressionistic, or oriented toward the lay reader, or they can be couched in the terminology of statistical analysis.

The closest preferred analogy is that of economic forecasting and the type of indicator that has become more or less common-place in developing national income projections, input-output ratios and projections, and econometric modeling generally.

An essential aspect of the evaluation would be to compare the behavior of one's institution to that of an appropriate comparable or compatible sample of institutions. Financial distress, however, is not just a relative matter; it is not merely the case of some institutions doing worse than others or than most. The industry as a whole or entire segments therein can be in financial distress.

Although the number of variables provided in the illustrations attached here is rather large, it is plausible to anticipate that a consensus can be reached according to which relatively few items need to be tracked. These will be items that embody the effects of several sub-variables.

More important than the number of items will be the identification of those that preview events yet to come. And here also the professionals ought to be able to agree on basic answers. Of course, controversy may be inevitable, given the predilection among academics to nit-pick. Still, similar to economic forecasting, we need some agreement on what are the leading indicators.

4. Who Should Be in Charge?

For too many years it may have been assumed that the proper place for higher education statistics is the National Center for Educational Statistics. Unfortunately, this meant among other things that we had educational statistics without the attendant theory of how educational institutions perform their services. Nothing could be clearer than that the structure of HEGIS Financial Reports is an obscuring and not a revealing set of statistics, if and when they see the light of day.

Again, I should like to use national income accounting as an example. There, a theory precedes the establishment of the required data structure, and as the theory changes, so do the requirements for data collection.

In higher education, fund accounting and not financial and program analysis has determined what we collect and how we must report it. As a result, it is well nigh impossible to interpret what is going on by looking at conventional finance data in higher education. If financial officers feel any comfort at all with the figures, it is because they have learned to read between the lines.

My first advice would be that the accountants not be in charge of the data design. My second recommendation is that the chief academic officer, program evaluators, and financial analysts with training in economics, balance sheet evaluation, and corporate finance be given a major crack at the task.

Finally, I think, it might be NACUBO that should become the focal point for financial distress analysis and data collection whether in the National Commission's frame of reference or some other broadly gauged and performance oriented context. The American Council on Education is another possible agency. The price index problem should be the government's, and the Bureau of Labor Statistics or the Bureau of Economic Analysis are well qualified for the task, since they have been in the price index construction business for many decades.

INDICATORS	Financially Sound Institution	Financially Weakening Institution	Financial Distress	Turnaround
I. ENROLLMENTS				
1. Total physical enrollment (body count)				
2. Total Academic Full Time Equiv. (HEGIS definition)				
3. Total Financial Full Time Equiv.*				
4. Ratio of line 2 to line 3 (2 ÷ 3) (two decimals)				
5. Number of applicants (complete application)				
6. Number of students admitted				
7. Number of students matriculated (two weeks into Fall term)				
8. Ratio of line 5 ÷ 6				
9. Ratio of line 6 ÷ 7				
10. Quantitative test score and high school rank or other performance profile of applicants				
11. Quantitative test score and high school rank or other performance of profile of matriculating students				
12. Identify non-quantitative aspects of student profile				
13. Financial Profile of Applicants				
a. Students admitted				
b. Students matriculating				
14. Financial aid profile of				
a. entering class				
b. returning class				
15. Others				
a. part-time students				
b. students housed				
c. students with board contracts				

* Total tuition income divided by total tuition charge -- before deducting financial aid

INDICATORS	Financially Sound Institution	Financially Weakening Institution	Financial Distress	Turnaround
II. FINANCIAL VARIABLES				
A. Operating Income (total & per student*)				
1. Changes in net tuition revenue (after Student Aid grants)				
2. Changes in endowment income				
3. Changes in auxiliary enterprise net income				
4. Changes in all other income before gifts				
5. Deficit before gifts; as % of total expenditures				
6. Changes in gift income				
7. Operating surplus/deficit as % of total expenditures				
B. Changes in Key Expenditures/per student (Financial Full Time Equivalent Student) Total and				
1. Instruction				
2. Library				
3. General Administrative				
4. Student Services				
5. Plant Maintenance (all plant)				
6. Auxiliary Enterprises (without plant maintenance)				
7. Student Aid				
8. Interest Expenditures				
9. All Other				
C. Assets, Liabilities, Ratios				
1. Total Short Term Assets at market: a. restricted				
b. unrestricted				
2. Total short term liabilities				
3. Current Ratio				

*Financial Full Time Equivalent Student

APPENDIX

INDICATORS	Financially Sound Institution	Financially Weakening Institution	Financial Distress	Turnaround
III. PROGRAM VARIABLES				
A. Instruction:				
1. Number of Departments				
2. Size of Staff by Department				
3. Number of Departmental Offerings				
a. types of major programs				
b. number of courses				
c. other				
4. Percent of Institutional budget				
B. Research:				
1. Staff actively engaged in productive research				
2. Number of staff				
3. a. Number of grants				
b. Size of average grant				
4. Number of projects, reports, publications				
5. Percent of Institutional budget				
C. Public Service:				
1. Staff actively engaged				
2. Number of activities				
3. Percent of Institutional budget				
4. Number of degrees granted at:				
a. each level				
b. each department				
D. Personnel:				
1. Staff Compensation				
2. Competitive ranking AAUP Scale				
3. Number of employees				

INDICATORS	Financially Sound Institution	Financially Weakening Institution	Financial Distress	Turnaround
C. Assets, Liabilities, Ratios (continued)				
4. Unrestricted net worth at market (on consolidated balance sheet basis)				
5. Accumulated surplus/deficit if any				
6. Reserves, sinking funds, etc.				
7. Ratio of long term assets to long term liabilities				
D. Special Ratios				
1. Debt amortization as % plant maintenance expenditures (minus amortization + interest)				
2. Interest expense as % of total expenditures				
3. Plant debt interest				
a. as % of plant maintenance expenditures				
b. as % of plant fund assets				
4. Depreciation as % of plant fund assets				
5. Plant fund liabilities as % plant fund assets				
6. Other				
E. Unrestricted Endowment at Market				
F. Fixed assets (land, equipment, plant) that can be sold				
G. Price and cost index numbers				
1. Wage index				
2. Price index				
3. Student Charges Index				
4. Others				
H. Separate documentation of debt structure, maturities, interest rates				

INDICATORS	Financially Sound Institution	Financially Weakening Institution	Financial Distress	Turnaround.
D. Personnel (continued): Ratios				
4. Teacher to student ratios				
5. Researcher to student ratios				
6. Administrative staff to student ratios				
7. Clerical personnel (nos.)				
a. to student ratios				
b. to staff ratios				
8. All other personnel to student ratios				
E. 1. Morale				
a. Work load				
b. Teaching load				
2. Other				
F. Condition of Plant and Equipment				
1. Annual plant maintenance expense				
2. Equipment purchase:				
a. New				
b. Replacement				
3. Plant depreciation reserves:				
a. Total				
b. Annual				
4. Deferred maintenance				
G. Other				
a.				
b.				
c.				